No. 10324

In the United States
Circuit Court of Appeals
For the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

vs.

CHINOOK INVESTMENT COMPANY,
a corporation,

Appellee.

APPELLEE'S BRIEF

On Appeal from the District Court of the United States for the District of Oregon.

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SUBJECT INDEX

SUBJECT INDEX (Continued)

TABLE OF CASES

Page

TABLE OF CASES (Continued)

Page

TABLE OF STATUTES

TABLE OF REGULATIONS

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APPELLEE'S STATEMENT OF THE CASE

Chinook Investment Co. is a corporation organized in 1911 under the laws of the state of Oregon

> "To own, buy, sell, or to acquire by sale, trade or exchange, bonds, notes, mortgages and other evidences of indebtedness or shares of stock in other corporations, and to exercise while the owner thereof all the rights, powers and privileges, including the right to vote thereon, that a natural person being owner thereof might, could or would exercise, negotiate loans and transact any other business usually trasacted by a credit or finance company." (Plff's Exh. 13, p. 101.)

It engaged in that business continuously thereafter to and including the years 1936 and 1937 here in question. At the time here in question the stock was owned as follows: Robert S. Farrell, Sr., 215, Robert S. Farrell Jr. 119, Marion Kingary 120, Susan M. Farrell 6, Frederick Kingary 10, Susan Kingary 10, Joan Farrell 10, and Sally Farrell 10 shares. The company was organized and operated for profit. (Tr. p. 107) Robert S. Farrell, Sr., acted as the buyer and seller of practically all stocks, bonds, and real estate and Robert S. Farrell, Jr., was manager of the company, looking after the real estate, renting and securing tenants, making repairs and other matters connected with the real estate. The other stockholders are a daughter and grandchildren. (Tr. p. 108) The corporation bought and sold securities at private sale, "at random", "over the counter", and "listed securities". It maintained an office for the transaction of the business of the company (p. 109). It bought from $200,000.00 to $300,000.00 worth of securities each year and sold about the same amount. It kept all the cash revolving in the purchase and sale of securities (p. 110). Mr. Farrell, Sr., kept in close touch with the market, "belonged" to Babson & Company, subscribed to financial papers

and periodicals, watched the stock market every day and "when I find something that looks reasonably well to buy or if I have something that looks well to sell I do buy or sell as I see fit." (p. 110) It had a number of unlisted securities, some in local companies. When it felt that the market justified, it bought or sold stocks. In making such sale or purchase it went to brokers. "often to outsiders" and ask them if they wish to buy what it had to sell. He knew the stockholders of these companies, attended annual meetings (p. 111). He conferred with them on prices. He made purchases direct from the owners of stock (p. 111). He was solicited frequently by brokers who had securities to buy or sell. These were for direct sales and not on any exchanges. They never bought or sold on margin (p. 112). All the purchases were for cash (p. 115).

> "We never salt it (securities) away, put it in a safe deposit box and say 'We will never look at it again,' saying it is a good investment. **That wasn't the idea of the company.**
>
> Q. THE COURT: In fact you figured on getting part of your living out of what you could make in your trading, didn't you?
>
> A. That is what I make my living at." (p. 116)

In its income tax returns the appellant described its business as "bonds, stocks, real estate". (Tr. p. 51) The bundle of invoices of purchases and sales of securities (Plf's Exh. 14-a and 14-b) were a part only of the invoices covering the transaction for the several years preceding the tax years in question. They are not a complete record of all the securities bought and sold. Appellee was unable to produce all of them, because some had been lost in moving. They disclose continu-

ous course of business in a variety of securities. The purchases were made in small and large lots. They were of low and high price and varied in every conceivable way.

It is conceded that appellee had no income in the years 1936 and 1937 subject to normal income tax.

In 1936 the company sustained a loss of $43,535.02 from the sale of securities which produced a net loss for the year resulting in a reduction of its surplus account by $26,935.64 (Tr. p. 26). The Commissioner of Internal Revenue assessed a surtax on "undistributed profits" of $4071.89 (tax and accrued interest) based on the contention that the loss was a "capital loss" and therefore deduction could only be taken to the extent of $2000.00. Appellee paid the tax and sued for a refund. This is the basis of the first cause of action.

In 1937 the company sustained a loss of $20,652.79 from the sale of securities, which produced a net loss for the year, resulting in a reduction of its surplus account by $16,810.12 (Tr. p. 27). The Commissioner assessed a surtax on "undistributed profits" of $5781.04 (tax and accrued interest) based on the contention that appellee was a "personal holding company" and the loss was a "capital loss" and therefore deduction could only be taken to the extent of $2000.00. Appellee paid the tax and sued for a refund. This is the basis of the second cause of action.

There is no dispute as to the figures found by the court below (Tr. pp. 26-27).

The only issues are those stated in the following statement of "questions involved":

THE QUESTIONS INVOLVED

I.

Were the losses "capital losses" within the meaning of **Section 117(b), Revenue Act of 1936** (applicable to both causes of action)? Appellee contends there is substantial evidence to support the finding of fact of the court below that appellee held the securities primarily for sale to customers in the ordinary course of its trade or business and hence they were not capital assets. The finding is not subject to review.

If this contention is sustained, then all other questions become moot.

II.

Even if they were "capital losses" they are deductible in full for the purpose of determining the existence of "undistributed profits" because there must be **profits in fact** available for distribution to stockholders as dividends as defined in **Section 115 of the Revenue Act** and not merely "statutory net income". This contention is applicable to both causes of action and if sustained, all other questions become moot.

III.

Even if they are "capital losses" and deductible only to the extent of $2000.00, there are no "undistributed profits" in either year because the deduction of the "dividends received credit" (**Section 26(b)** results in no "undistributed profits".

IV.

As to the year 1937 (second cause of action) appellee was not a personal holding company because the

revenue from rents was more than 50% of the total "gross income" (**Section 353, Revenue Act of 1937**) and therefore does not come within the definition of personal holding company (**Section 352**).

V.

If **Section 14 of the Revenue Act of 1936** (undistributed profits tax) and **Sections 351 to 359 of the Revenue Act of 1937** (personal holding company act) are construed to mean that a tax on "undistributed profits" must be imposed on appellee even though it has no **profits in fact** in the current tax year available for distribution as dividends to stockholders, then as so construed the act is unconstitutional because it is not a tax on "income" (**16th Amendment**) but a penalty for failure to distribute capital.

POINT I.

The losses did not result from the sale of "Capital Assets". Appellee was therefore entitled to a deduction of the entire loss and was not limited to a deduction of $2000.00 under Section 117(d) Revenue Act of 1936).

SUMMARY OF THE ARGUMENT

A.

The question whether the securities were "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" was determined by the court below as a question of fact and is therefore not subject to review.

B.

The taxpayer does not have to be a "dealer or merchant of securities" as defined in Regulation Art. 22 (c)(5) in order to come within the purview of the last clause of **Section 117(b)**. The true test is whether the securities were purchased and held with the intention of selling the same and realizing a profit therefrom as distinguished from a purchase for the purpose of deriving revenue (interest or dividends) therefrom.

C.

If the business of buying and selling securities is carried on regularly and the transactions are continuous and frequent as distinguished from isolated or casual, then the securities dealt in are not "capital assets" within the definition of Section 117(b).

D.

Anyone who can be found to buy property, including a broker who buys for an undisclosed principal, is a "customer" within said section.

E.

The definition of "dealer" or "merchant" of securities in Art. 22(c) (5) cannot be read into and made a part of Sec. 117(b) because the definition in Art. 22 (c)(5) is made "for the purpose of this rule" only. It is not made a part of Sec. 117(b) by reference or otherwise. The former defines the **status of the taxpayer** while the latter defines the status of the **assets**.

F.

The term "business" as used in Sec. 117(b) is that which occupies the time, attention and labor of men

for the purpose of a livelihood or profit.

G.

Appellee's activities were not limited to doing merely what was necessary from an investment point of view such as merely collecting dividends and interest. It was an active and continuous buyer and seller and engaged in all activities incident thereto as a means of earning profits for its stockholders.

H.

The length of time the securities are held is not decisive, if they were acquired and held primarily for resale.

ARGUMENT

Appellant sustained a loss of $43,535.02 (not questioned) in 1936, and $20,652.79 (not questioned) in 1937 from the sale of securities. It is conceded that if these securities were not "capital assets" as defined in **Section 117(b) of the Revenue Act of 1936** (applicable to both causes of action), then appellee was entitled to deduct the losses in full and there were no "undistributed profits" subject to the penalty in either year.

The question then presents itself were these securities "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business?"

This calls for an inquiry into the taxpayer's trade or business and the purpose and intent with which the securities were purchased and held. These are primary questions of fact to be determined by an ap-

praisal of all the facts and circumstances developed by the evidence and the inferences to be drawn therefrom. The court below made findings of fact which bring the appellee within the definition of the clause quoted above. (Tr. pp. 27-28.)

This court has held that the precise question here involved was a question of fact. That the finding of the court below, if supported by substantial evidence, is not subject to review.

In **Richards v. Commissioner, 81 Fed. (2d) 369 (9th Cir.)**, this court held:

> "The Commissioner contends that the real property in question was not a capital asset, and the issue presented to the Board was whether or not the real property was 'held by the taxpayer primarily for sale in the course of his trade or business.' The determination of this issue is the ultimate fact. (Citations.)"

The Board determined the ultimate fact to be:

> ". . . . . that the lots were held by the petitioner primarily for the sale in the course of his business. . . . .
>
> "We are limited therefore to an examination of the record to ascertain whether or not there is any substantial evidence to sustain the finding." (Citing many cases.)

It has been repeatedly said that it is the province of the trial court to determine the facts and to draw the inferences therefrom.

Under the **Richards case** decided by this court the question is foreclosed by the finding of fact made by the court below and is decisive of this case.

Appellant maintains that the question is reviewable as one of law or mixed question of law and fact and cites the **Boeing case, 106 F. (2d) 302.** That case does not overrule the **Richards case.** This court merely held in the **Boeing case** that the **Richards case,** and others, "must be read in the light of the more recent expressions of the final court". This had reference to the cases of **Helvering v. Ranking, 295 U.S. 123,** and **Helvering v. Tex-Penn Co., 300 U.S. 481.** These two cases merely clarified the distinction between "primary", "evidentiary" or "circumstantial facts" which "must be taken as established" and the "ultimate finding" which is a "conclusion of law". Applying this test to the case at bar, the findings which were quoted above, are all upon facts from which the court below made its "conclusion of law" or "ultimate finding" (Tr. p. 30).

All of the details narrated in the findings of fact are primary, evidentiary, and circumstantial from which the ultimate finding or conclusion was drawn. It was the sum total of these facts and the inferences drawn therefrom that led to the determination (ultimate conclusion) that the securities were not "capital assets".

We submit that there is ample evidence in the record to support these findings and that the findings support the conclusion.

Appellant's analysis of the evidence as to the nature of appellee's business ignores many important factors disclosed by the evidence. It ignores the fact that the taxpayer is a corporation which was organized for

the express purpose, among others, of buying and selling securities. It was engaged in that business for over thirty years.

Mr. Farrell, Sr., the President, devoted practically all of his time to that portion of the business which had to do with the purchase and sale of securities. His son handled the rental of real property and offices were maintained for the conduct of the business. They made a living out of trading in securities. (Tr. p. 116) They did not buy securities to salt away as an investment. (Tr. p. 116) They bought and sold for cash only. Mr. Farrell solicited buyers as well as sellers. They frequently bought and sold from hand to hand in private transactions. He kept the capital of the company constantly revolving in the purchase and sale of securities. The capital was turned over about once a year. This type of business was continuous during the years they were in business. The transactions were not intermittent or occasional but were continuous and regular. They did not speculate on margin. Mr: Farrell participated in the management and activities of some of the corporations in which it held stock. He kept in close continuous touch with the market and was a subscriber to the financial publications and services. He watched the stock market for the purpose of enabling him to conduct the business of buying and selling securities. Mr. Farrell testified "we always bought and sold for a profit, tried to do so". **(Tr. p. 116)**

Investment "was not the idea of the company". **(Tr. p. 116)**

The sheaf of invoices in evidence, representing purchases and sales, are not all of the invoices covering all of their transactions. They were all that could be found, but there are enough in evidence to demonstrate the activities of the corporation, the regularity of its transactions, the variety of transactions and negative the idea that securities were being purchased and held merely as investments.

The evidence adduced fulfills all of the tests which have been applied by this and other courts as well as by the Board of Tax Appeals for determining that securities were held primarily for sale to customers in the ordinary course of business.

Appellant's failure to appreciate the significance of the evidence is due to the fact that it has attempted to apply tests which are not contemplated by **Section 117(b)**. Appellant's entire argument is an attempt to draw this case into an ambit of **Regulations, Article 22(c)(5)** following **Section 22(c) of the Revenue Act** instead of the tests contemplated by **Section 117(b)**. All of the so-called legislative history that is referred to in appellant's brief except the brief excerpt on Page 18 are concerned with the statute and Regulations under **Article 22(c)** and other provisions of the Revenue Act.

Appellant insists throughout that in order to come within the exception of the last clause of **Section 117(b)** the taxpayer must be a "dealer" or a "merchant" of securities as the term is defined in **Regulations, Article 22(c)(5)**, and that the Act must be interpreted in

accordance with said Regulations. This is the backbone of appellee's argument.

We reproduce here in juxtaposition **Section 117(b)** and **Regulations, Article** 22(c)(5) for the purpose of comparison.

Section 117(b)

"(b)—**Definition of capital assets**—For the purposes of this title, 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . . . . property held by the taxpayer primarily for sale to customers in the ordinary course of **his** trade or business."

Article 22 (c)-5.

"Art. 22 (c)-5. **Inventories by dealers in securities.** . . . . **For the purpose of this rule** a dealer in securities is a **merchant** of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a **merchant** buys securities and sells them to customers with a view to gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as here provided may include only those held for purposes of resale and not for investment. **Taxpayers who buy** and sell **or hold** securities **for investment or speculation**, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, **are not dealers** in securities **within the meaning of this rule.**"

The two cannot be read together for the following reasons:

First, they deal with entirely different subject matters. The **regulation** deals with the right to use inventories reporting the taxpayer's operations. The **act** defines capital assets.

Second, the regulation deals with the status of the **taxpayer** (whether "dealer" or "merchant"). The act deals with the status of **assets.**

Third, the regulation specifically provides that it is promulgated "**for the purpose of this rule**" thus limiting its application. The act creates a definition "for the purpose of this **title**". Title has reference to the entire body of income tax law.

Fourth, the regulation includes specific characteristics such as "merchant of securities", "established place of business". The act does not include these characteristics.

Fifth, the regulation specifically excludes from the definition of dealers in securities those who buy and sell or hold securities for "**investment** or **speculation**", "irrespective of whether the buying or selling constitutes carrying on of a trade or business." The act does not exclude the taxpayer who buys, sells or holds securities for "**investment or speculation**". The phrase "irrespective of whether such buying or selling constitutes carrying on a trade or business" in the regulation is highly significant and important. This particular language was not included in the 1928 regulation. The phrase was undoubtedly added in recogni-

tion of the fact that one can be regularly engaged as a dealer in securities as a business or trade even though he buys and sells for investment or speculation. In order to remove the investor and speculator from operation of that definition specific amendment had to be made and was made.

But Section 117(b) does not exclude the **investor or speculator** and so the sole test remains the purpose to hold **primarily for sale.**

Sixth, If the Congress intended that the definition in Section 117(b) should be co-extensive with the definition in Article 22(c)-5, or that the former should be interpreted in accordance with the latter, it would have incorporated the same language which had acquired fixed meaning or would have incorporated the same by appropriate reference. In failing to insert an amendment in 117(b) corresponding to the amendment of Article 22(c)-5 which includes the phrase "irrespective of whether such buying or selling constitutes the carrying on of a trade or business", with respect to investors and speculators, there was manifest recognition that the two provisions are not related to each other.

Regulations, Article 22(c)(5) does two things in connection with the definition of dealer of securities. It first defines who shall be a "dealer" or a "merchant" and then specifically says who shall not be deemed a "dealer" or "merchant" "within the meaning this rule". There is no comparable language in **Section 117(b)** which is the applicable statute. Very

comprehensive language is used. It does not deal with securities alone as does the Regulation. It deals with "property", "all" property. The Regulation deals with a specific kind of business, to-wit: the security business. **Section 117(b)** deals with "his" trade of business. The Regulation excludes the investor and speculator even though investment and speculation is carried on as a business. **Section 117(b)** does not exclude either.

It is a universal rule of statutory construction that when a statute deals with a specific subject matter and makes its own definitions, that it cannot be extended by implication to cover other matters, particularly when they are specifically dealt with elsewhere. The rule of ejusdem generis makes it impossible to read into **Section 117** the definitions and interpretations which appellant seeks to incorporate.

Appellant attaches great significance to the insertion of the words "to customers" and "ordinary" by the 1934 amendment. It is claimed that these words require that 117(b) should be construed as defined in Regulation 22(c)(5). But this Court and the Board of Tax Appeals have held otherwise in decisions interpreting 117(b) as amended.

In **Ehrman v. Commissioner of Internal Revenue,** 120 F. (2d) 607-610 (9th Cir.) this court said:

> "From the cases it would appear that the facts necessary to create the status of one engaged in a 'trade or business' revolve largely around the **frequency** or **continuity** of the transactions claimed to result in a 'business status.' We see no reason

> for departing from these decisions and now holding that the fact that property is sold for the purposes of liquidation forecloses a determination that a "trade or business" is being conducted by the seller. See also Welch v. Solomon, 9th Cir., 99 F. (2d) 41."
>
> . . . .
>
> "The taxpayers call attention to the fact that the statute involved was **amended** in 1934 by adding the words 'to customers' and 'ordinary'. It is urged that the addition of these words indicate an intention by Congress to exclude from taxation as ordinary gains sales such as the ones with which we are here concerned. We do not agree. If, as we have held the fact to be here, the taxpayers were in the 'trade or business' of real estate subdivision, then certainly the sales of lots were to 'customers' in the 'ordinary' course of that business."

This court thus held applicable the tests applied by this court in the **Boeing** (106 Fed. (2d) 659) and **Richard's** (81 Fed. (2d) 369) cases.

In the **Richard's** case the emphasis was placed on the "comprehensive" word "held" and so this court ruled that even though the property was not originally purchased for resale, it was not capital assets if thereafter "held" for resale.

In the **Boeing** case this court held that the question as to the status "revolve largely around the **frequency** or **continuity** of the transactions." It is not a question whether the taxpayer holds for "investment", for the court quoting from the **Miller** case, 102 Fed. (2d) 476, said:

> "If the transactions concerning his investments are **substantial** and **frequent** as distinguished from occasional or isolated,"

then the taxpayer comes within the exception and so it was there held, applying the test of "regularity" and "continuity" as distinguished from "casual" transactions that, the gains were not "capital".

The Boeing case involved the tax for 1934 and the statute **as amended.**

Under the **Boeing** and **Miller** cases the test is not whether the property was held for "investment". Even if investment if the "taxpayer's investment activities" stand the test of continuity and regularity so that investment was a business, the exception applied.

In support of the view the court also referred to Kales vs. Commissioner, 101 Fed. (2d) 35 (6th Cir.), and Kane v. Commissioner, 100 Fed. (2d) 382 (2nd Cir.).

The recent case of **Black v. Commissioner,** 45 **B.T.A. 204-209, dec. Sept. 1941,** involved the application of **117(b)** as amended. The taxpayer was engaged generally in the real estate business consisting primarily of subdividing tracts of land. The board found the following facts:

> "Petitioner bought, developed and traded in real estate for sale at a profit. He did not buy real estate to hold as an investment. His plan of operation was to buy property and develop it and rent it, if necessary, while awaiting sale so as to show an income and then sell it when he could."

He developed a number of subdivisions through a corporation and dealt principally in residential property but also bought and sold business property. During the tax year in question he had four properties

which he had acquired from one to ten years prior thereto. In 1924 he traded a farm property for a building known as the Franklin Building, giving mortgages back on the building. There was a lease on the building when he acquired it but after some two or three years the tenant vacated and the building remained vacant. The mortgages on the building were foreclosed, and as the result thereof the taxpayer sustained a loss in 1936. The Commissioner of Internal Revenue disallowed the loss except to the extent of $2000, treating the building as a capital asset. The Board of Tax Appeals held:

> "It is obvious from the record that the Franklin Building was acquired by petitioner and Gould for the purpose of selling it and was continuously held for sale from the time it was purchased until it was lost on foreclosure sale.
>
> "Where, as here, one is regularly engaged in the business of buying and selling real estate, as was petitioner, **any person who can be found to buy such property is a customer,** as that term is ordinarily understood, and where such property is held for sale under such circumstances it must be deemed to be held for sale to customers within the meaning of the statute."

The reasoning employed by the board as late as September, 1941, and in the face of the **Farr and Burnett cases** with which the board was undoubtedly familiar, clearly dissipates the contention of the appellant in this case that the 1934 amendment made a radical change so as to bring only dealers and merchants within the purview of the last class of **Subdivision (b)**. The emphasis was placed by the board upon the intent with which the property was acquired and held. If it

was bought for the purpose of resale to make a profit thereon, then it was "held" primarily for sale to customers".

In **Goodman v. Commissioner, 40 B.T.A. 22**, the taxpayer purchased a tract of land, subdivided it into lots for the purpose of selling the same to such purchasers as may be found. Part of the lots were sold and then the project became inactive and remained so for several years. The taxpayer then surrendered the remaining property to the holder of the mortgage in satisfaction of the indebtedness. The taxpayer also paid some $900.00 to boot to be relieved of the mortgaged debt. He took a deduction of the loss sustained upon the disposition of the property. The loss was disallowed by the Commissioner on the ground that the property was a capital asset. The case also involved **117(b) after the 1934 amendment.**

Upon these facts the Board held that the property was "held primarily for sale to customers in the ordinary course of the taxpayer's business", notwithstanding the fact that the property remained "inactive" for a long period of time. The delay was explained by a slump in the real estate market. The Board said:

> "The original purpose, however, remained. It cannot be that business adversity of itself converted it into a purpose of investment, nor did the demand of the mortgagee. Those seem to us to have been disappointing incidents of the primary purpose of ordinary business—no less so than a failure to succeed in the grocery business."

It is argued that to be entitled to take a deduction of the entire loss sustained from the sale of **securities**, one must be a "dealer" or "merchant" of securities. The idea urged is that the taxpayer must be a dealer in the very kind of property which resulted in loss. This idea was rejected by the Board of Tax Appeals in **Forston vs. Commissioner of Internal Revenue, 47 B.T.A. Case No. 26**, decided June 23, 1942, involving the statute as amended. (See text of decision, Appendix p. 81.)

In **Hercules Motor Co., 40 B.T.A. 999**, the question also arose under the statute as amended and it was held that trade acceptances taken in payment of merchandise and later sold at a loss were not capital assets. (See text of decision, Appendix page 82.)

The Commissioner of Internal Revenue has not been consistent in his interpretation of the act in question. His views seem to depend upon which side of the fence he is on. In the **Richards case** when the Commissioner was contending that the transaction came within the exception he advanced the same interpretation that we do here. We quote from the Commissioner's brief filed in this court in that case, (No. 7835) as follows:

> "In the recent case of Roney v. Commissioner, 67 F. (2d) 165 (C.C.A. 4th), certiorari denied, 290 U.S. 705, the court pointed out that, even though slight, the activities of the taxpayer were continuously carried on between the years 1922 and 1925, and concluded that (p. 166) 'very slight activity' constitutes 'doing business' when the end is profit."

This was the test he wished to have applied. This Court adopted the Commissioner's views in the **Richards case** and did so largely upon the authority of three cases decided by the Supreme Court of the United States which adopted a very comprehensive definition of the term "business".

In **Flint vs. Stone Tracy Co., 220 U.S. 107,** the first of the three cases, the Court held:

> "* * * 'Business' is a very comprehensive term and embraces everything about which a person can be employed. Black's Law Dict. 158, citing **People ex rel. Hoyt vs. Tax Comrs., 23 N.Y. 242, 244.** 'That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.' "

In **Von Baumbach vs. Sargent Land Co., 202 U.S. 503**, the second of the three cases cited, the Supreme Court reiterated its approval of that definition.

In **Sloan v. Commissioner, 63 F. (2d) 666 (9th Cir.)**, this Court adopted this definition.

The position taken by appellant in the case at bar is diametrically opposed to that which it took in the **Richards case.**

The emphasis placed by appellant on the interpretation of the words "to customers" is unwarranted.

In **Commissioner v. Stevens, 78 F. (2d) 713,** the taxpayer was a stock broker, but in addition to buying and selling for others on commission, bought and sold stocks for its own account and "all their pur-

chases were intended for resale at a profit". In considering whether it sold "to customers" the court said:

> "Another broker may well be considered a customer."

And in the **Black case, 45 B.T.A. 204**, the Board of Tax Appeals as late as September, 1941, said that

> "Any person who can be found to buy such property is a customer. . . ."

In **Marsch v. Commissioner of Internal Revenue, 110 F. (2d) 423-425 (7th Cir.)**, the court, after reciting the taxpayer's activities, said:

> "These activities were **regular** and **recurrent** and **not those of a mere passive investor**, and show a related **continuity** of a dealer regularly engaged in the business of buying and selling real estate. Dalton v. Bowers, supra; Kales v. Commissioner, supra; and Commissioner v. Boeing, 9th Cir., 106 F. (2d) 305."

In **Quaker Investment Co. v. Commisisoner, B.T. A. memorandum opinion, Docket No. 88723, April 12, 1939**, the taxpayer was a corporation organized "with power to purchase, sell and deal in stocks and other securities". From the time of its inception the company was engaged in buying and selling stocks and securities. During the tax year in question it made a profit from the sale of certain stocks and sustained losses from the sale of others which it offset against the profits. The Board, in construing the language "or property held by the taxpayer primarily for sale in the course of his trade or business", held the losses deductible in full. (See text of decision, p. 82 of Appendix.)

In **Alverson vs. Commissioner of Internal Revenue, 35 B.T.A. 482**, the taxpayer was a lawyer actively engaged in the practice of law. "That was his principal business". He was also engaged in buying and selling stocks and securities for his own account. The Board in determining whether he was engaged in "any trade or business" said:

> " 'Any trade or business' is the broad language of the statute. We, therefore, conclude that taxpayer, in dealing on the stock exchange to the extent he was during the taxable year, was carrying on a trade or business within the meaning of the statute. . . . . ."

In **Fuld v. Commissioner, 44 B.T.A. 1268, decided August 22, 1941**, the Board found the facts to be that **prior to 1930** the taxpayers bought stocks merely as investors and were not engaged in buying and selling of securities as a business, but they bought the securities for investment purposes.

But **after 1930** they adopted a new policy. "They began purchasing in large lots . . . for the purpose of making rapid turnover . . . Fuld devoted time to the study of financial papers, attended meetings of corporations, and 'the main source of livelihood of both petitioners was from their securities transactions.' "

Upon these facts the Board made a finding of fact "beginning Oct. 9, 1930 through 1933 petitioners were **engaged in the business of trading in securities**", and held:

> "Despite the investment status of all their activities before, the petitioners maintain that their

activities in which they were engaged under their new policy constituted the business of trading or speculating in securities. We are convinced that they have sustained their burden of establishing this fact. Jackson v. United States, 25 Fed. Supp. 613; affd., 110 Fed. (2d) 574; see also Clinton Gilbert, Jr., Executor, 20 B.T.A. 765. The petitioners' activities were not 'limited to doing merely what was necessary from an investment point of view', and their transactions 'were substantial and frequent rather than occasional or isolated.' Alice DePont Ortiz, 42 B.T.A. 173. Moreover, besides devoting a large part of their time to their new activities of buying and selling securities for their own accounts, the principal source of their livelihood resulted from such activities. In our opinion, the petitioners' activities constituted the business of trading in securities in 1933 . . . .

. . . .

Therefore, we hold that the losses from the sale thereof in 1933 are not capital losses within the meaning of section 101 of the Revenue Act of 1932."

In **Reckford v. Commissioner, 40 B.T.A. 900 (1939)** the Commissioner took a position diametrically opposed to the position asserted in this case and was sustained by the Board of Tax Appeals. The taxpayer was the president of a large manufacturing concern. He also engaged for many years in buying and selling securities. That part of his activities tapered off very sharply from 1929 to 1934. In the years, 1932 to 1934, they were almost neglible compared to his former trading. The Board held:

". . . . In determining whether a trade or business was being carried on, a factor of more decisive importance than the volume of transactions lies in whether or not the taxpayer's market activities consisted of dealing in securities for speculative

purposes, or for investment purposes.

"Thus the court in Kales v. Commissioner, 101 Fed. (2d) 35, reversing 34 B.T.A. 1046, held that where the taxpayer made all decisions affecting the sale or purchase of securities and employed a bookkeeper with whom she held conferences three or four times a week, such activities were sufficient to take her out of the class of a **passive investor**; that she was **carrying on a trade or business.**

. . . .

"But it has also been held that the **management of investments may constitute a trade or business.** . . . ."

In **Jackson v. U. S., 110 Fed. (2d) 574 (9th Cir.)** in determining that the taxpayer was engaged in trade or business the Court pointed out:

"This is not a case where the business activities were so limited as to be merely incidental, as held in Lansdowne v. Commissioner of Internal Rev., 50 F. (2d) 56 (2 U.S.T.C. Sec. 748); Garner v. United States, 49 F. (2d) 993 (1931 C.C.H. Sec. 9401); and other cases cited by appellant. Here **supervisory acts were so extensive, continuous, and necessary as to constitute the doing of business** under any reasonable definition of that term."

In **Miller v. Commissioner, 102 Fed. (2d) 476 (9th Cir.)**, the Court, in considering whether the taxpayer was engaged in trade or business, said:

"The Supreme Court has defined 'business' in passing on a case under the corporation excise law, as being a very comprehensive term, embracing everything about which a person can be employed and as that which occupies the time, attention and labor of men for the purpose of a livelihood or profit. Flint v. Stone Tracy Co., 280 U.S. 107, 171."

. . . .

"Other cases have recognized that though the taxpayer takes no part in the enterprises as to which he is an investor, he may nonetheless be considered to be carrying on a business if the transactions concerning his investments are substantial and frequent as distinguished from occasional or isolated." (Citing many cases.)

"In addition to the cases cited, two Circuit Court cases have very recently been decided which applied, in ascertaining the character of the taxpayer's investment activities, the test of the extent of those activities. We think that these two cases, taken together, establish a proper measure for the determination of whether a taxpayer's activities are of a 'business' character."

The two cases referred to are the **Kales case, 101 F. (2d) 35,** and **Kane, 100 F. (2d)** 382. In the former the court held that the taxpayer was engaged in business because her activities

". . . were extensive, varied, continuous and regular', and on this basis concluded that they constituted a business."

In the latter case the court found from a review of the evidence that the taxpayer was merely a "passive recipient of income". Thus we have the clean-cut line of demarcation recognized and approved by this court.

In the **Kales case,** the Court, in determining that the taxpayer was engaged in trade or business said:

"That ordinarily a person is engaged in business when he devotes his time and energy to the buying and selling of securities there can little doubt, and the Supreme Court has, inferentially at least, recognized it."

. . . .

"Likewise is there little doubt that one who as a mere investor passively received his income from

corporate stocks and bonds is not carrying on a business even though prudence requires that he change his investments from time to time. . . .

. . . .

"The line of demarcation between a passive investor and one whose activities place him in the category of those carrying on business has been clearly recognized by the Board of Tax Appeals, Alice P. Bachofen von Echt, 21 B.T.A. 702 (C.C.H. Dec. 6543), upon rehearing November 8th, 1932; Caroline T. Kissel, 15 B.T.A. 1270 (C.C.H. Dec. 5034), April 15th, 1929. In each case the taxpayer was an investor, but an active one.

. . . .

"It would be impossible in the brief space of an opinion and serve no useful purpose to detail all her activities. It is sufficient to say that they were **extensive, varied, continuous and regular,** and in no substantial manner to be distinguished from the activities of the taxpayer in the Kissell and von Echt cases, and in that of Bula E. Crocker, 27 B.T.A. 588 (C.C.H. Dec. 7905) cited by the dissenting Board member."

The principle of those cases applies with greater force in the case at bar because **here the taxpayer is a corporation** chartered to **engage in business for profit** and **not an individual.**

It is argued that the securities sold in 1936 and 1937 were purchased some years prior thereto. But that does not mitigate against the fact that they were held primarily for sale. If purchased with the intention of resale and held for that purpose, the length of time that they were so held is unimportant. In the **Black case, 45 B.T.A. 204,** the property was held 11 years. The Board held that that did not make the property capital assets in view of the evidence that the property was bought for re-sale and so held thereafter.

In the **Fuld case** the securities were owned for several years prior to resale. In fact they were purchased at a time when the taxpayer was not engaged in the business of buying and selling securities. They were purchased when he was merely an investor. He later engaged in the business of buying and selling and thereafter held those securities for the purpose of resale. It was held that the securities were not capital assets. Thus the period of time the particular securities were held (even though the original intention was not for resale) does not make the securities capital assets.

It is pointed out that the taxpayer received "dividends on stock in substantial amounts" but the receipts of dividends is merely incidental to the stock ownership. The receipt of dividends would only be significant if the stock had been purchased for investment merely. But when purchased for the purpose of resale the receipt of dividends is incidental. In the **Black case** the taxpayer received $7,000 a year rental from the property in question from a tenant who held possession under a lease and it was held that the receipt of rent from the property was merely incidental to its ownership.

It is asserted that the taxpayer's president admitted that the securities were purchased as investment and his testimony at page 120 is referred to. The testimony is as follows:

> "Q. Now, Mr. Farrell, you testified that you were buying and selling securities for the corporation for a **profit** to the corporation, for an invest-

ment for the corporation, isn't that right?

A. For what?

Q. The corporation was investing in stocks, wasn't it?

A. Yes.

Q. Yes, and you as president and secretary of the corporation handled that end of the business?

A. Yes."

It is obvious that Mr. Farrell understood the term as used in counsel's cross question in the sense that all property purchased is in a large measure an investment. The retail merchant invests in merchandise and the "dealer" in securities invests in securities. The word "investment" is used in the same breath as the word "profit". The question includes both words. Moreover this excerpt must be read in the light of all his testimony.

The real question is whether the property was "held" "primarily" for sale or whether it was held for the purpose of deriving revenue therefrom. While the term "capital assets" is defined by the statute the very definition and exceptions indicate that basically the term is employed in about the same sense as it is understood in business generally. In business any property that is acquired for the **purpose of resale** and to make a **profit** therefrom is treated as merchandise in a broad sense. But property that is bought and retained for the purpose of **deriving revenue** therefrom such as **rent, interest, dividends** and the like is regarded as capital. If one buys machines for the purpose of reselling them and making a profit, the machines are merchandise. If he buys the same machines for the purpose of utilizing them to manufacture articles from

the sale of which he hopes to make a profit, they are capital assets.

The farmer who has a herd of cows for the purpose of milking them and selling the milk and cream holds the cows as capital assets and an incidental purchase or sale from time to time to improve his herd would be purchase or sale of capital assets. But if the same farmer bought and sold milk cows as a regular business, the cows would be merchandise and the revenue derived from milking while he owned the cows would be merely incidental to the business of trading in cattle.

CASES CITED BY APPELLANT

The cases of

Schaefer v. Helvering, 299 U.S. 171,
Vaughn v. Commissioner, 85 Fed. (2d) 497,
Trading Associates v. Magruder, 112 Fed. (2d) 779, and
Seeley v. Commissioner, 77 Fed. (2d) 323.

cited by appellant have no bearing upon the case at bar.

None of the cases referred to above involve the interpretation and application of Section 117(b).

In all of those cases the courts were concerned with the meaning of the term "dealer" as used in other sections and for entirely different purposes.

The **Schaefer case** did not involve the question of "capital assets". It did not involve the question of the allowance or disallowance of any losses. The specific question there involved was whether securities which

the taxpayer had on hand at the end of the tax year in question (1929) were to be valued at cost or market. They were concerned with securities on hand and not securities which had been sold resulting in the loss. The question depended upon the interpretation of **Section** 22 of the **Revenue Act of** 1928 and **Treasury Regulation 74, Articles 101 and 105** (later number Art. 22(c)-5) which was promulgated pursuant to the specific authority conferred by **Section 22.**

The Board of Tax Appeals isolated the issue in the Schafer case as follows:

> "They assign as error: (1) the respondent's determination that the partnership of Schafer Bros. was **not entitled to inventory at market** value securities on hand. . . . .
> The Commissioner determined . . that they must be carried at cost."

In determining that issue the Board pointed out:

> "However, the purpose of the statute and the quoted regulation was to provide a means for the correct reflection of income **resulting from a definitely limited character of business.**"

and again the Board said:

> "The meaning of 'dealer in securities', as **defined in the controlling regulation,** has been considered many times by the courts, and this Board."

The inapplicability of that section and said regulations has already been demonstrated (page...... to ...... this brief).

It is highly significant that Section 117(b) is not followed by any Regulations similar to 101 and 105 which follow Section 22.

Neither does the Regulation following Section 117 (b) make any reference to Article 105 or any other section or regulation for the purpose of incorporating definitions or interpretations contained therein.

The **Vaughn case** involved the same statute and regulations and the same issues as the **Schaefer case.** There, too, the question was as to the right of the taxpayer to employ inventories as to securities on hand and what has been said in reference to the **Schaefer case** is equally applicable to the **Vaughn case.**

In the **Seeley case, 77 Fed. (2d) 323,** cited by appellant, the issue was stated by the court as follows:

> "This appeal raises the question of taxpayer's power to have his income tax for the year 1929 computed by the use of inventories under Section 22(c) of the Revenue Act of 1928."

The inapplicability of that section to the case at bar has already been demonstrated. The interpretation or application of Section 117(b) was not raised, discussed or passed upon by the Court. The taxpayer in that case was a speculator buying and selling stock on margin and as such the court held that he was not a "dealer in securities" as defined in Regulation 22 (c)-5. The reasoning employed in that case and the comparison which the Court made between that case and the case of **Re Hall, 29 B.T.A. 1255,** even when applied to the term dealer in securities supports our views. In the **Hall case** the Board held the taxpayer to be a dealer in securities and entitled to inventory the unsold securities at market, because in that case the taxpayer bought and sold securities as a business. He was not

merely speculating on margin as in the **Seeley case.** The contention was made in the **Hall** case that because the taxpayer sold his securities through brokers that he was not selling "to customers" and did not therefore come within the purview of Regulation 22 (c)-5, but the Board held:

> "He argues that the partnership did not make sales of its securities to customers, because one who deals on a stock exchange is not a merchant in securities, selling to customers. . . . . . .
>
> . . . .
>
> We see no reason why a broker, in such circumstances, may not properly be regarded as a customer of the partnership . . . .
>
> . . . .
>
> We know of no good reason why a broker, even though acting for an undisclosed client, should not properly be regarded as a customer in the making of repeated purchases of securities owned and held for resale by the partnership.
>
> "In our opinion, however, the controlling factor here is not the method by which the partnership obtained customers or made sales. It is the fact that the partnership purchased securities and held them not for investment or speculation, but for resale at a profit to anyone who desired to buy.
>
> "A grocery merchant might, and as a matter of common knowledge often does, purchase goods through a broker, and he might resell through a broker or agent or clerk to whom he pays a commission. But such method of carrying on his business would not change the fact that he was a merchant in groceries, if he purchased and carried groceries in stock for resale at a profit to customers."

The **Trading Associates case** did not involve the interpretation or application of Section 117(b). It in-

volved the interpretation and application of **Section 351(a) of the Revenue Act of 1934** and the **Regulations, Article** 351-2 promulgated in connection therewith. This statute and the regulations define "personal holding company". The statute excepts "regular dealers in stock or securities". The **Regulation 351-5** makes its own interpretation of "dealers in securities" which is to a large extent similar to but not the same as **Regulation 105** (Art. 22(c)-5) referred to above, but the statute and regulations involved in that case differ radically from the statute and regulations involved in the case at bar, so far as the issue of "capital assets" is concerned.

It is significant that in each instance where the term "dealer in securities" is used, that the regulations include a comprehensive definition and interpretation of that term as it is to be used in that connection, while in the regulations following Section 117(b) there is no definition or interpretation similar to the regulations following the other sections. Indeed, there is no regulation which purports to interpret the meaning of the term "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business".

In the **Trading Associates case** there was no issue as to whether the securities bought or sold constituted captial assets. It did not involve the allowance or disallowance of any "loss". The only question there involved was the status of the taxpayer as a "personal holding company".

The application of **Section 351** is involved only to the extent of determining the status of the appellant as a "personal holding company" in 1937. It has no bearing upon the question whether the securities were "capital assets" in either year. That question is governed by **Section 117(b)** solely.

The **Burnett case** involved the deduction of losses sustained by an **individual** taxpayer, not a corporation. The loss resulted from "stocks and commodities" held in her **margin** account with brokers. The case involved the Revenue Act of 1934. The Circuit Court of Appeals held:

> "Under the rule laid down in Higgins vs. Commissioner . . . . . the investment or speculative activities of the taxpayer were not sufficient to warrant a conclusion that she was engaged in a trade or business within the meaning of Section 23(e) (2) of the Revenue Act of 1934."

Section 23(e) deals entirely with "losses by individuals". Losses by **corporations** is dealt with in Section 23(f). In the case of individuals the losses are deductible.

> "(1) If incurred in trade or business; or
>
> (2) if incurred in any transaction entered into for profit though not connected with the trade or business."

These limitations are not attached to subdivision (f) of section 23 relating to corporations. It reads:

> "In the case of a **corporation** losses sustained during the taxable year and not compensated for by insurance or otherwise. . . . ."

The decision by the Board of Tax Appeals in the **Burnett case, 40 B.T.A.** 605, does not set forth any findings of fact or any summary of the evidence as to the manner in which the taxpayer carried on her transactions. There is only the bare conclusion that "petitioner's stocks and commodities held in her **margin** account with brokers were not held for sale to customers in the ordinary course of taxpayer's trade or business within the meaning of the Revenue Act of 1934". The decision of the Circuit Court of Appeals does not set forth any summary of the evidence or pertinent facts from which that determination was made. The only comparison that can be made is that there the taxpayer operated a **margin account** with brokers while the taxpayer in the case at bar bought and sold outright and held the securities purchased primarily for sale, which is diametrically opposed to the finding made in the **Burnett case.**

Insofar as the Circuit Court of Appeals discusses the application of Section 117(b) it is quite apparent that the Court erroneously applied the test of "dealer in securities" as defined in regulation Article 22(c)-5 (1934). The Court held:

> "There is substantial evidence to support the finding of the Board that Mrs. Burnett was not a 'dealer in securities' . . . .
> The taxpayer was not entitled to use inventories in determining net income . . . ."

These factors are not present in Section 117(b).

In this respect the decision of the Court of Appeals of the Fifth Circuit is diametrically opposed to and

ignores the tests which this court has adopted and adhered to for determining what are "capital assets" within the meaning of 117(b).

> Ehrman v. Commissioner, supra.
> Commissioner v. Boeing, supra.
> Richards v. Commissioner, supra,
> Miller v. Commissioner, supra.
> Jackson v. Commissioner, supra.

In the case of **Farr vs. Commissioner, 44 B.T.A. 683,** cited by appellee, the taxpayer was a member of a partnership composed of eight members. The partnership was engaged in the stock brokerage business, buying and selling for others, but it also bought and sold stocks for its own account. "The firm did not solicit sales (of its own securities) to private persons." **The firm treated the stock purchased for its own account as capital assets in its accounting system, reported them as such in the partnership returns and made distribution of profits to the partners on that basis.** But the individual partner, the taxpayer in that case, in making his own income tax return, did not treat such stocks as capital assets and reported a loss of his share of the loss sustained by the partnership upon the sale of securities in the current tax year. The Board of Tax Appeals, in rejecting the taxpayer's contention, recognized that the taxpayer's contention was "pursuasive" but felt itself bound by the decision in the **Burnett case.** The **Farr case** is distinguishable upon the facts. The individual partners' position was inconsistent with the status accorded the securities by the partnership itself in its accounting practices, distribution of profits and in making the firm's income

tax return. Obviously the individual partner could not acquiesce in that treatment by the partnership, accept his share of the profits from the partnership upon that basis and then reject that basis for the purpose of reporting his own income tax. Furthermore the practice of buying stock for the firm's own account was merely incidental to its business which was that of stock brokerage, the buying and selling of stock on the stock exchange for others. It is obvious, too, that the Board in that case erroneously applied the "dealer" and "merchant" test which is not applicable under **Section 117 (b).**

The Board was clearly in error when it said that the 1934 **amendment to Section 117(b)** was designed to make it mean the same as **Section 23(r)** (now 117 (d)), for 117(b) defines "capital assets" while 23(r) was (117(d)) is merely a limitation or deduction if the loss is from capital asests as defined in 117(b). If it had been the intention of the Congress to make **Section 117(b)** applicable to dealers as that term was used in other sections of the act and as interpreted in the regulations following those sections, the Congress would have employed the same language or would have referred to those definitions.

The **Farr case** and the **Burnett case** are not in harmony with the views of this court as to the proper test to be applied to **Section 117(b).** Those two cases ignore the elements of regularity and continuity, the test to which this court stands committed.

In the **Burnett case** the taxpayer traded altogether on margin. Stocks held on margin cannot be said to be

stock held for sale to customers in the ordinary course of business. A margin account is in reality merely a gamble on the turn of the market. The speculator never does have either possession or title to the stock which he buys or sells on the market. That is not true with the outright buyer of securities. The decisions in both cases were largely predicated upon the fact that the taxpayer was engaged in **margin trading.**

RE LEGISLATIVE HISTORY

It is asserted that soundness of the decisions in the **Burnett and Farr cases** (Page 15) is demonstrated by the legislative history of **Section 117 of the Revenue Act of 1936.**

We submit that the excerpts and references which follow (except the quotation on page 20) do not refer to **Section 117(b).** They have reference to other sections of the act which set up their own definitions for the specific purposes therein described.

The legislative history of **Section 23(r)** later made 117(d) is not relevant for it only fixes a limitation. The limitation on the amount of losses which was introduced in 1932 was not accomplished by changing the definition of "capital assets". In 1932 the section which corresponds to **117(b)** was **101(c)(8).** It read.

> "Property held by the taxpayer primarily for sale in the course of his trade or business."

No change was made in that phraseology when the changes were made in **Section 23(r).**

In 1934 the provision limiting capital losses to $2000.00 was transferred from 23(r) to 117(d) and that became the provision of limitation. The only change that was made in **Subdivision** (b) was the introduction of the words "to customers" and the word "ordinary". The references made on Pages 16 and 17 of appellant's brief refer to the amendment of **Subdivision (d)** which fixes the limitation, but not to **Subdivision (b)**, which defines capital asests. Nothing that was said in those committee reports was said with reference to **Subdivision (b)**.

On Page 18 appellant discusses the first of the two clauses in **Subdivision (b)**, to-wit: the exclusion of stock in trade which would properly be included in the inventory. We are not concerned with the interpretation of that clause. We are concerned only with the concluding clause.

On Page 19 it is argued that for sale "to customers" must be construed in accordance with the provisions of **Article 22(c)(5) of Regulations 94.** But that regulation has nothing whatever to do with the definition of capital assets. **Section** 117(b) defines capital assets. The regulation referred to does not attempt to deal with the question as to what is and what is not capital assets. It only determines when and under what circumstances "dealers in securities" as defined "for the purpose of this rule" may or may not be permitted to use inventory values for the purpose of computing gross income with respect to securities which are on hand. It has nothing whatever to do with determining what is "capital assets".

Attention is called to the fact that the phrase "for sale to customers" was used in the committee report on **Section 23(r) of the 1932 Revenue Act.** The fact remains that the phrase was not incorporated into that act and even if it had been incorporated therein, it would not affect the interpretation of the definition in **117(b)** because **23(r)** (now 117(d) is only a limitation if the loss results from sale of capital assets. It does not define capital assets. 117(b) defines the term.

The only excerpt from any committee report which discusses **Section 117(b)** is the phrase quoted on Page 20 of appellant's brief reading:

> "Thus making it impossible to contend that a stock **speculator** trading on his own account is not subject to provisions of Section 117."

This observation cannot be stretched into meaning that investors in securities whose investment business is extensive and regular and continuous so as to constitute a business, is eliminated from the last clause of **117(b).** The business of investment in securities is not even referred to in that observation. Neither is there any intimation in that observation that only a dealer in securities, as the term is used in **Regulation 22(c) (5)** is to be excluded from the operation of the last clause of **117(b).** The only one referred to in the observation is "**speculator**" and that obviously has reference to the one who trades on margin and is in and out of the market to make a profit on the turn of the market. There is not the slightest suggestion in that observation that it was intended to deal with those who buy and sell securities as a regular business on an

extensive basis and maintains a regular place of business for that purpose and devotes all or substantially all of his time to the management and operation of that business.

There is no warrant for the assumption that the Congress "believed" that the term "to customers" would be construed as applying to merchants or dealers of securities, as the term is used in other sections, or that the Congress intended to change the law as it was laid down in the **Purdy case, 32 B.T.A. 542, aff'd. 102 F. (2d) 331 (1st Cir.).** If the Congress had intended to exclude from the definition of capital assets only such securities as were held by "dealer" or "merchant" of securities as the term was used in other sections reference to those sections would have been made or similar language would have been employed.

If the addition of the words "to customers" and "ordinary" had been intended to affect as extensive a change in the interpretation of the language of **Subdivision** (b) as is here contended for, one would expect to find a substantial **change in the regulations promulgated by the Treasury Department following the section.** The Treasury Department would have at once supplemented the regulation to state its interpretation in language which would make clear that it was intended to limit the exception to dealers or merchants in securities.

A comparison of the regulation following **Section 101** of the **1932 Act (Article 501, Regulations 77)** with the regulation following 117(b) of the **Revenue Act of**

1934 (Article 117-1, Regulations 86) discloses that the Treasury Department did not so construe the amendment. All that is there said is:

> "The term 'capital assets' includes all classes of property not specifically excluded by Section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a 'capital asset' the period for which held is immaterial."

There is no suggestion in that regulation that the act as amended was to be construed or was construed by the Treasury Department as here contended for. The corresponding regulation in 1936 was no more extensive.

It is argued in effect (p. 20) that the committee had confidence that by the insertion of the words "to customers" that section 117(b) would then be construed in accordance with the definition of "dealers in securities" as laid down in Regulation 22(c)(5). There is not the slightest foundation for this assumption. If the Congress wanted to limit the application of the last clause of 117(b) to those who came within the category of Article 22(c)(5), it would have said so in so many words or would have referred to that regulation.

Neither is there any justification for the assertion that the committee was led to believe that the amendment would read into section 117(b) the definition contained in Article 22(c)(5) by any "judicial construction". Not a single case is cited which in the slightest degree lends weight to such an idea.

POINT II.

Even if the securities sold were capital assets the full loss must be deducted to determine the existence of "undistributed profits" because the penalty is imposed on undistributed profits in fact, available for distribution as dividends to stockholders as defined in Section 115 of the Revenue Act and not upon statutory net income.

SUMMARY OF ARGUMENT

A.

The purpose of imposing a penalty for failure to distribute profits was to force payment of dividends to stockholders so that they would become subject to surtax. This purpose negatives the idea that the penalty is imposed where there are no profits to distribute.

B.

The statute imposing the penalty must be construed most strongly against the government and in favor of the taxpayer.

C.

While "net income" may be determined by application of the statutory formula, "profits" available for distribution cannot be created by legislative fiat. A corporation cannot be penalized for failure to distribute when it has no profits to distribute.

D.

Both sections here involved impose the penalty on the "undistributed" profits. This presupposes the existence of profits in fact which could be distributed as dividends and not mythical profits.

E.

Section 115 defines dividends as any distribution of "earnings or profits".

F.

For the purpose of determining the existence of "undistributed" profits, the entire loss from sales of securities must be deducted even though deemed to be "capital losses" and when so computed appellee had no undistributed profits in either of the two years in question.

ARGUMENT

Assuming without conceding that the losses resulted from the sale of capital assets, they must nevertheless be deducted in full for the purpose of determining the existence of "undistributed" profits and it is conceded that if the entire loss was deductible appellee had no "undistributed" profits in the two years in question. There is no issue of fact in this respect and if this contention is sustained all other questions in the case become moot.

It must be remembered throughout that Sections 14 and 352 do not impose a tax on "net income".

The tax on "net income" of a **corporation** is provided for in Section 13. They impose a **penalty** for failure to distribute profit. This distinction must be kept in mind in considering the construction and application of the two sections.

The Sixteenth Amendment to the Constitution authorizes the imposition of a tax on "income". A penalty has been held to be income and authorized by the

Sixteenth Amendment **only** when it is a means of preventing evasion and enforcing the collection of taxes on income. A penalty to force distribution of profits, so that share holders could be taxed on the income so received, would be deemed a tax on income.

But if the corporation had no profits in fact to distribute, the penalty is then imposed on a failure to distribute "capital" and not "income" and does not come within the Sixteenth Amendment which authorizes a tax on income.

The "undistributed profits" Act was enacted in 1936 and was made applicable to that tax year.

At that time there were already in existence statutes designed to prevent the use of the corporation as an "incorporated pocketbook" for the purpose of avoiding the imposition of surtax on the individual stockholders, to which they would become subject upon distribution of corporate earnings as dividends.

Section 102 deals specifically with corporations which were "formed or availed of" in a given tax year for the purpose of avoiding the imposition of surtax on stockholders.

Section 351 "cracked down" on "a personal holding company" if it failed to distribute its profits, and for that purpose the holding company was given a statutory definition which brought within its ambit many corporations which were not holding companies in the sense in which the term was generally understood.

The purpose of the Act was:

> "(1) **to prevent avoidance** of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequalities between corporate, partnership and individual forms of business organization, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates."
> (House Ways and Means Committee Report.)

Section 14 died in infancy. In 1938 the law was **entirely overhauled** and every feature of it which laid the tax upon "undistributed profits" was eliminated. Even the title "undistributed profit" was expunged and there was substituted the title "tax on special classes of corporations". Corporations were divided into classes according to the size of the income and a rate of taxation based upon such graduated income was incorporated. It ceased to be an "undistributed profits" tax.

In 1939 "the remaining vestiges of undistributed profits tax" were completely removed. (Mertens Law of Federal Income Taxation, Page 1581).

We respectfully invite attention to the following rules of construction as applied to revenue acts.

Statutes levying taxes should not be extended by implication beyond the clear import of the language used,

> "or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government and in favor of the citizen."
> **(Gould vs. Gould, 245 U.S. 151.)**

This applies with greater force to taxes which are in the nature of penalties.

> **Mead Corp. v. Commissioner, 116 Fed. (2d) 187 (3rd Cir.)** (involving penalty for failure to distribute profits).

In **Hoeper v. Commissioner, 284 U.S. 206**, the Supreme Court said:

> "That which is not in fact the taxpayer's income cannot be made such by calling it income."

Neither can that which is not profit constitute "undistributed profit".

Tax laws should be construed and applied

> "with a view of avoiding so far as possible unjust and oppressive consequences. . . . . ." **(Farmers' Loan & Trust Co. v. Minnesota, 280 U.S. 204.)**

In **United States v. Ryan**, 284 U.S. 167, the Court said:

> "A literal application of a statute which would lead to absurd consequences is to be avoided whenever a reasonable application can be given which is consistent with the legislative purpose."

In **Rhodes v. Commissioner of Internal Revenue, 100 Fed. (2d) 966 (6th Cir.)**, the Court said:

> "Common sense interpretation is the safest rule to follow in the administration of income tax laws. Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and **in the determination of taxes men sould measure both by ordinary, everyday business standards.** Compare Woolford Realty Co. v. Rose, Collector, 286 U.S. 319, 332 (3 U.S.T.C. Sec. 938); United States v. Hardy, 74 F. (2d) 841 (4 C.C.A.) (35-1 U.S.T.C. Sec. 9060)."

In **Washington Southern Co. vs. Baltimore Co., 263 U.S. 629,** Judges Brandeis said:

> "To ascertain the true meaning of the rule, the operation and effect of the construction urged must be considered."

A fact cannot be brought into existence by "legislative fiat," which does not and cannot be made to exist "in actuality". **(Heinier vs. Dounan, 285 U.S. 312.)**

And so we contend in this case that profits available for distribution cannot be created by "legislative fiat". That is so because the penalty is for failure to distribute and a corporation cannot distribute profits when it did not earn any in fact.

The emphasis must be on the term "undistributed" which presupposes that there are profits to distribute. Distributable profits can no more be created by legislation than by magic.

The first cause of action involves Section 14 of the Revenue Act of 1936 which is titled **"Surtax on Undistributed Profits"**.

The second cause of action involves Sections 351-357 of the Revenue Act of 1937 titled **"Surtax on Personal Holding Companies"**.

The former imposes a tax of certain graduated percentage of **"undistributed"** net income (Section 14(b)) and the latter imposes a tax on the **"undistributed"** adjusted net income (Section 351).

In both cases it is a tax on that which is "undistributed" and this **pre-supposes the existence of profits**

in fact which could have been distributed as dividends to stockholders and were not distributed.

Distribution of profits by corporations are made by means of dividends and dividends are defined in Section 115 as any distrbuton made by a corporaton out of "earnings or profits". Indeed that is the accepted understanding of the term dividend, even in the absence of statute. Distributions of capital are regarded as liquidating dividends. Since the surtaxes are imposed upon the "undistributed" profits earned in the **current** tax year there must, of course, be profits earned in that year available for distribution. Of course if a corporation sustains losses in a given year through any cause whether it be from the sale of assets or excessive operation expenses or through fire, accident or other causes, which are greater than its profits, there cannot be any profit in fact and hence no "undistributed profit".

The surtaxes on "undistributed profits" relates only to profits earned in the **current tax year.** They do not penalize failure to distribute earnings of **prior** years (Corporate Investment Co. vs. Commissioner, 40 B.T. A. 1156—see text at page 87 of Appendix.)

Statutory net income does not truly reflect the taxpayer's **actual earnings** during a given year and would deprive the Government of the right to the application of the penalty in many cases where there is **actual profit** in the year's operation, **although no statutory taxable income.** For example, a corporation may have income of $10,000 from normal operations and in addi-

tion thereto $50,000 of income from Government securities which are exempt for normal tax purposes. Thus the taxpayer has an actual income of $60,000 and yet it has only a statutory taxable income of $10,000. In such a case, if the statutory net income is to be the test in determining whether there is "undistributed" profits, then the taxpayer would not be subject to the surtax even though $50,000 of the year's income remains "undistributed".

The revenue law permits many deductions in arriving at net income which result often in wiping out statutory net income, notwithstanding the fact that there was **actual profit in the year's operation.**

Obviously Congress never intended that Section 14 should not apply to cases where there were **actual profits** available for distribution as dividends and yet no statutory net income.

On the other hand, there are cases in which there may be statutory net income and yet **no actual profit** because the Revenue Act only permits certain specific deductions for the purpose of arriving at statutory net income. A corporation may actually pay very large salaries to officers yet it would not be permitted to take a deduction for all of the salaries so paid over and above an amount which the Commissioner deems reasonable. Many other limitations are placed upon deductions in arriving at statutory net income so that the statutory net income bears no relation to the actual result of the year's operation.

Obviously the existence of "undistributed profits

cannot be computed on the basis of statutory net income in the latter case, and upon the basis of actual net profits in the former case.

The **Internal Revenue Department has itself ruled that losses sustained must be deducted in full** in order to determine the existence of "undistributed profits".

Income Tax Ruling 3253,—1939—1 Cumulative Bultin, Part I, Page 178, is as follows: (See text of ruling, p. 83 of Appendix.)

This was a clean-cut ruling that the **entire loss** must be deducted in determining "undistributed profit".

The idea that net loss can be tortured into being profit, was apparently shocking to the **Supreme Court**.

In **Woolford Realty Co. v. Rose,** 286 U.S. 319—52 **Sup. Ct.** 568 the Supreme Court, speaking through Justice Cardozo, said:

> "There are two fundamental objections to this method of computation. In the first place, an interpretation of net income, by which it is also a net loss, involves the reading of the words of the statute in a strained and unnatural sense. The metamorphoses is too great to be viewed without a shock. **Certainly the average man suffering a net loss from the operations of his business would learn with surprise that, within the meaning of the Congress, the amount of his net loss was also the amount of his net income.**"

If a dividend must be paid out of capital or earnings of prior years, it cannot be distribution of "earnings or profits" of the **current year.**

There is no language in Section 117(d) which spe-

cifically requires that the $2,000.00 limitation should be applied to the computation of undistributed profits. Section 117(d) in its present form was enacted in 1934 prior to the enactment of Section 14 (1936), so that it cannot be said that it was contemplated when enacted that it would be applied to the computation of undistributed profits.

Section 14 contains no language which makes applicable the $2,000.00 limitation in computing undistributed profits.

To adopt appellant's theory we would have to imply the application of the limitation. But statutes are never construed to imply the imposition of penalties and certainly not to produce "unjust and oppressive consequences".

It is argued that the existence of undistributed profits must be determined by the formula outlined in Sections 21, 22 and 23 of the Revenue Act. But those acts merely provide the formula for computing the normal tax. They are not designed as a formula for computing "undisputed profits".

In the **Weyerhauser case, 33 B.T.A.** 594, it was argued that "earnings and profits" must be computed in the same manner as "statutory net income" and the Board said:

> "This argument loses sight of the fact that Congress, in enacting section 23, was concerned only with deductions to be allowed in computing net income; it was neither defining earnings and **profits,** nor providing a method for computing them."

In that case it was the taxpayer who was urging that earnings and profits should be computed in accordance with the formula in Sections 21, 22 and 23. The Commissioner of Internal Revenue took the opposite view and was sustained by the Board of Tax Appeals. See text of decision, p. 84 of Appendix.)

The Supreme Court rejected that idea in **U. S. vs. Pleasants, 305 U.S. 357.** There, too, the Commissioner attempted to apply the same formula. The Court said:

> "We are not impressed with the argument based on the provisions of Sections 21, 22 and 23, 26 U. S.C.A. §§ 21-23. True, Section 21 provides that 'net income' means gross income computed under Section 22 less the deduction 23. Section 22 defines gross income and Section 23 provides for deductions, including deductions for losses. **But Sections 21, 22 and 23 are not to be construed so as to derogate from the special and explicit provisions of Section 101(b).**" (1932 Act same as 117(b) 1936 Act.)

The Board of Tax Appeals and the courts have recognized and have given effect to a clean-cut distinction between "statutory net income" and "earnings or profits". The former is a purely statutory concept and does not take into account all of a taxpayer's income (for it excludes revenue derived from government, state, county, etc. bonds (Sec. 22(b)(4) and other types of securities), and does not take into account all deductions which go to decrease or wipe out profits. As for example, the $2,000 limitation on capital losses, and extraordinary legitimate expenditures not allowable for statutory income tax purposes.

Whereas the latter term "earnings or profits" deals

with **realities**, profit or loss **in fact** and not the arbitrary statutory concept.

A taxpayer may or may not have net income for normal tax purposes within the arbitrary statutory provisions but "dividends" can only be paid out of actual **profits** and not profit by fiat.

In **Chas. F. Ayer v. Commissioner, 12 B.T.A. 284**, the Board of Tax Appeals clearly pointed out the difference between "net income" upon which income tax is paid and "profit" out of which dividends are paid, and concluded by saying:

> "It therefore follows that the earnings or profits mentioned in section 201(a) of the Revenue Act of 1921 (same as Sec. 105 of 1936 Act) are **not the equivalent** of the **taxable net income** of the corporation. In this connection see National Grocery Co., 1 B.T.A. 688, and Lynch v. Hornby, 247 U.S. 339."

In **W. S. Farish & Co. v. Commissioner**, 38 **B.T.A. 150—affd. 104 Fed. (2d) 833 (5th Cir.)**, the Board of Tax Appeals held:

> "**The rule (computation according to statutory formula) is applicable only in computing taxable net income**, that is, the income upon which Congress has levied a tax. Thus, taxable **net income is purely a statutory concept, and bears no relation to gains and profits subject to distribution as dividends.** (Citations.) It is the **actual gain** or loss which affects the corporation's capital and **determines whether there is earned surplus, or a deficit** which impairs the capital."

In **McKinney v. Commissioner, 32 B.T.A. 450—affd. 87 Fed. (2d) 811**, the Board of Tax Appeals said:

"The substance of the government's argument seems to be that the statute requires that 'earnings or profits' of a corporation, as the term is used in section 201, supra (same as Section 115) must be determined in the same manner and on the same basis as its taxable income. That the statute does not so provide is, in our opinion, well settled. See our discussion in Charles F. Ayer, 12 B.T.A. 284. . . . .
Section 201(d) on its face **distinguishes between 'earnings or profits'**, as used in subsection (a), **and taxable net income** . . . ."

In **Elmhirst v. Commissioner, 41 B.T.A. 348**, the Board of Tax Appeals held:

"We first examine the question of proper basis for computation of **profit or loss**: Respondent concedes that the Board has decided this question adversely to him in W. S. Farish & Co., 38 B.T.A. 150, and Ida I. McKinney, 32 B.T.A. 450; affd. 87 Fed. (2d) 811, to the effect that for the purpose of ascertaining the amount of earnings and profits available for distribution as dividends, **cost** to the corporation should be used **rather than** the **statutory basis** for **determinating gain or loss for** purpose of computing tax. Since W. S. Farish & Co. has been affirmed, 104 Fed. (2d) 833, by the Circuit Court of Appeals for the Fifth Circuit, and since the same conclusion, in effect, in F. J. Young Corporation, 35 B.T.A. 860, has been affirmed by the Circuit Court of Appeals for the Third Circuit, 103 Fed. (2d) 137, further discussion of this point is unnecessary, and we hold, in accordance with said cases, that the proper basis is the basis of cost to the corporation. The **same decisions require a holding against the respondent upon** two minor items entering into the **computation of profit or loss** of the corporation, to-wit, whether \$287,586.36 is an allowable deduction for losses for 1932 from sale of securities held less than two years, losses on wash sales, and taxes; and wheth-

er $144,979.18 is an allowable deduction for the year 1933 because of adjustment to cost of securities sold, and losses on wash sales. **The same logic dispositive of the above cases indicates that such deductions, though not to be taekn into consideration in arriving at taxable net income, should be deducted in computing earnings or profits of the corporation in the determination of avails for distribution."**

In the case at bar we claim the right to deduct losses in full for the purpose of computing the existence of "undivided profits". There is no language in Section 14 (undistributed profits tax Act) or in Section 351 of the Revenue Act of 1937 (personal holding company tax act) which specifically directs that losses (except to the extent of $2,000) should be excluded in computing the existence or non-existence of undistributable profits nor is there any language in the Acts which makes Section 117(d) applicable in either case.

In the case at bar we are concerned with the question whether profits were made **in the current year** (Foley case, 106 Fed. (2d) 73; Northwest Steel Co. case, 311 U.S. 46, and Crane-Johnson case, 311 U.S. 54) **which could have been distributed as dividends** (not a distribution of capital, or profits made in former years).

Profits or losses in prior years cannot be considered in determining the existence of "undistributed profit" of the current year. (Corporate Inv. Co. vs. Com., 40 B.T.A. 1156, see p. 87 of Appendix.) Profits of prior years pass to surplus account and become capital. (Macomber case, 252 U.S. 189.)

Since the existence or non-existence of profits available for distribution as dividends must be determined from the year's operations as a whole without regard to prior years, the plaintiff in this case had no "undistributed" profits in either year out of which it could have legally declared a dividend. The losses sustained wiped out the earnings for the years and reduced the surplus account.

Under the formula used by the writer of the Treasury Department memorandum when applied to the case at bar there was no undivided profits in the tax year in question.

Appellant is grossly mistaken when it asserts (p. 12)

> "That surtax on undistributed profits has been sustained in situations where the corporate taxpayer has had nothing available for distribution."

Three cases are cited in support of this assertion, **Northwest Steel Mills, Crane-Johnson Co. and Foley Securities cases.** In every one of them the corporation **actually earned profits in fact in the current tax year.** In none of them did the taxpayer attempt to set off any losses against the profits.

In the **Foley case** the profits were **actually distributed** as dividends. In the **Northwest Steel** and **Crane-Johnson cases** the profits were not distributed. In those two cases the taxpayer claimed that it was precluded from making such distribution because it was under contractual duty to refrain from doing so, that the contracts came within the provision of **Section 26-c** and

therefore was entitled to the deduction provided for therein.

There were no losses sustained or claimed. There were profits in fact and there is not the slightest intimation in any of those cases that a "surtax on undistributed profits" can be imposed **when there are no profits in fact.**

The validity of the act was attacked in those cases, but it was sustained on narrow ground that the act deals with the income **"for each taxable year"—"a definite period"**—that is, the **current annual profits.** The court held the act valid "as applied" to those taxpayers because they had actually earned profit **in the current year** and it was upon that profit that the surtax was imposed. The reasoning employed, implies that if the surtax had been imposed where there were no actual profits, the act would be deemed invalid.

Assuming without conceding that the losses were "capital losses" they would nevertheless have to be deducted **in full** to determine the existence of "undistributed profits". When so computed there were none in the years in question.

POINT III.

Assuming without admitting that the deduction for the losses are limited to $2,000.00 in each year, appellee had no undistributed profits in either year because he was entitled to take the deduction of the dividend received credit (26(b)) in determining the existence of "undistributed profits".

ARGUMENT

Section 26(b) of the Revenue Act in force in both years provides that **corporations** should be allowed a credit to the extent of 85 per cent of the revenue received from dividends on stock owned by the company. This credit was provided for, because the corporations paying the dividends had already paid income tax upon the profits which were distributed as dividends.

Section 13 which imposes the income tax on corporations specifically makes section 26(b) applicable. It says:

> "As used in this title the term 'normal—tax net income' means the net income minus the sum of—
>
> . . . .
>
> (2) Dividends received—the credit provided in Section 26(b)."

Appellee took this credit in computing its income tax in both years and its right to do so has not been and is not now questioned.

If appellee is entitled to take this credit in determining the existence of "undistributed profits" then there were no undistributed profits in either year, even

though losses are limited to $2,000.00. This, too, is not questioned. The findings of fact set forth (Tr. pp. 26 and 27) the essential figures. They are not questioned. The only issue raised in this respect, is the right as a matter of law to take this credit in computing undistributed profits.

These figures show that in 1936 the gross revenue was $38,873.30. The deductions for salaries, rent, taxes, et cetera were $14,331.45, leaving $24,541.85. The dividend received credit (to-wit 85 per cent of $27,145.09 dividends, Tr. 51) was $23,073.32. The loss from sale of securities (if 117(d) is held applicable) was $2,000.00. The total credits are $25,073.32 which is in excess of the aforesaid profits.

In 1937 the gross revenue was $43,787.61. The deduction for repairs, interest, taxes, et cetera was $26,674.11, leaving $17,113.50. The dividend received credit (85 per cent of $25,188.70 dividend, Tr. 85) was $21,410.49, which of course largely exceeds the profits even without any deduction for losses from the sale of the securities.

In a very real sense the dividend received credit in the case of corporations is not a credit at all. When section 26(b) is read together with Section 13, it becomes apparent that the Congress intended that only 15 per cent of the revenue received by corporations from dividends on stock of other corporations should be treated as income.

We submit that section 14 which imposes the penalty on undistributed profits as well as Sections 351

to 356 of the Revenue Act of 1937 (personal holding company act) require the allowance of the dividend received credit in both instances in computing "undistributed profits".

Now Section 26 provides

> "In the case of a corporation the following credits shall be allowed to the extent provided in the **various** sections imposing tax—
>
> "(b) Dividend received—85 per cent of the amount received as dividends. . . . . ."

This provision is applicable to **all** sections of the Revenue Act "imposing tax". It is not limited to any particular section or particular tax. The language is very clear. It says as provided in the **various** sections imposing tax.

The provision is comprehensive and cannot be limited in its application to the computation of the normal tax and excluded from the computation of the tax on "undistributed profits".

In the formula for determining the amount of the surtax on undistributed profits, net income is the starting point. Net income so far as **corporations** are concerned must mean the net income as it is computed in the case of **corporations** for normal tax purposes under the formula provided in Section 13 and this requires specifically the deduction of the dividend received credit.

Section 351 of the Revenue Act of 1937, applicable to the second cause of action, imposes the surtax upon the "**undistributed** adjusted net income". The formula

for determining undistributed adjusted net income are provided for in Sections 355 and 356. When read together they make "net income" the starting point for computation. Here, too, the computation must be made in accordance with Section 13 which is applicable to **corporations**, and produces the same result as the computation under Section 14.

Appellant asserts that the dividend received credit is not here relevant (page 10) and in the footnote says that this credit is not allowed in computing the surtax on undistributed profits.

No decisions are cited in support of this assertion. We submit that the sections of the act referred to above require that the dividend receiving credit Section 26 (b) be allowed under **all** sections of the Revenue Act "imposing tax". It is not limited to the sections imposing normal tax only.

POINT IV.

Appellee was not a personal holding company within the meaning of Sections 352 and 353 of the Revenue Act of 1937.

SUMMARY OF ARGUMENT

A.

Appellee was not a personal holding company because revenues from rents constituted more 50 per cent of the gross income.

B.

Gross income for the purpose of these sections is not synonymous with gross receipts.

C.

"Gross **income**" within the meaning of sections 352 and 353 must be computed by deducting from gross **"receipts"** the cost of the property. As so computed, the rents were more than 50% of the gross income.

ARGUMENT

A "personal holding company" is defined as follows:

> Sec. 352. . . . . the term "personal holding company" means any corporation if—
>
> (a) . . . . at least 80 per centum of its gross **income** for the taxable year in personal holding company income as defined in section 353.
>
> . . . .
>
> Sec. 353 ". . . . for the purpose of this title the term 'personal holding company income' means the portion of the gross **income** which consists of:

(a) Dividends . . . . .
(b) Stock and Securities Transactions . . . .
(c) Commodities Transactions . . . . .
(d) Estates and Trusts . . . . .
(e) Personal Service Contracts . . . .
(f) Use of Corporation Property by Shareholder . . . . .
(g) Rents.—Unless constituting 50 per centum or more of the gross income. . . . ."

Appellee's gross income did not bring it within the foregoing sections of the Revenue Act.

"Gross income" is not synonymous with gross receipts.

Article 402-2 Regulations 101 says:

> "In determining whether the personal holding company income is equal to the required percentage of the total gross income, the determination **must not be made upon the basis of gross receipts, since gros sincome is not synonymous with gross receipts.**"

Article 351-2 Regulation 94 says:

> "**Gross income is not synonymous with gross receipts.** For example, in the case of a sale or exchange of property, it **includes only the excess** of the **amount realized** therefrom **over** the **adjusted basis provided** for in section 113(b).
>
> . . . .
>
> "Gains from all transactions involving stock in trade, etc., are **determined for the taxable year as a whole instead of separately.**"

Regulation (a)-1 (1938) says:

> "Gross income includes in general . . . profits from sales of and dealings in property . . . in general income is the gain derived . . . from . . . profit gained through selling or conversion of capital assets."

Article 22(a)-5 (1936) says:

> "Art. 22(a)-5 Gross Income from Business.—In the case of a manufacturing, merchandising, or mining business 'gross income' means the **total sales, less the cost of goods sold,** plus any income from investments and from incidental or outside operations or sources . . . ."

In **United States v. Guggenheim Exploration,** 238 **Fed.** 231, the Court said:

> "The word 'income' is not synonymous with the word '**receipts**'. Von Baumbach v. Sargent Land Co., 219 Fed. 31, 134 C.C.A. 649."

In **Greensboro Gas Co. v. Commissioner, 30 B.T.A.** 1362 the Board of Tax Appeals held:

> "Gross income from business in which sales of property are involved does not include the cost of the property sold. The capital outlay for the cost must be subtracted from gross receipts. **We must keep in mind the distinction between gross receipts and gross income.** The depletion deduction is based **on gross income** and **not gross receipts.** The situation represented here is analogous to that of a merchant who is required to **deduct from** his **gross receipts** the **cost of goods sold** in determining gross income. It is only the latter which is the basis for computing depletion in the case before us."

From the foregoing regulations and decisions it is obvious that the gross income of appellee represents the **receipts** from all sources including the sale of securities less the cost of the securities sold.

Appellee's "gross income" was derived from the following:

(a) Dividends and interest.
(b) Stock and securities transactions.
(g) Rents.

Appellee's gross receipts in 1937 were as follows:

From sale of securities	$43,239.27
Interest	180.00
Rents	18,418.91
Dividends	25,188.70
TOTAL RECEIPTS	$87,026.88
Cost of Securities	$63,892.06
GROSS INCOME	$23,134.82

The amount received from the sale of securities and the cost are shown in the schedule which is part of plaintiff's exihibit 5 and reproduced on page 89 of the transcript. The figures quoted constitute the totals of the two columns headed "sale price" and "cost".

The revenue from interest, rents and dividends is shown in the schedule which is part of plaintiff's exhibit 5 appearing at the foot of page 85 of the transcript. There is no issue in this case as to the accuracy of these figures.

Since the rents were $18,418.91 they are of course more than 50 per cent of the gross income of $23,134.82.

Since the rents must be excluded in computing the personal holding company income the remainder which constitutes personal holding company income, to-wit, $4,715.91, is less than 80 per cent of its total gross income. Appellee does not therefore come within the definition of personal holding company (Section 352).

POINT V.

If the Acts in question are construed so as to preclude the deduction of the total loss in determining the existence of undistributed profits and are not limited to profits in fact, then the Acts as applied to appellee are unconstitutional because (a) they do not impose a tax on income but on capital and (b) they are so arbitrary as to violate the due process clause of the Constitution.

It is recognized that the purpose of both acts here in question was to "compel corporations to distribute their current earnings to stockholders so as to increase their tax liability".

In **Foley Securities Co. v. Commissioner, 106 Fed. (2d) 73** (8th Cir.), the court said:

> "There can be no doubt that the purpose of Congress in enacting Section 351 was to compel each personal holding company to distribute its **current earnings** instead of accumulating them, so as to augment the income of its shareholders thereby increasing the amount of their tax liability."

In **Bastian Bros. Co. v. McGowan, 32 Fed. Sup. 93**, the Court said:

> "The statute (referring to Section 14—Undistributed Profit Tax) was enacted **to check evasion** of surtax on corporation earnings by leaving them undistributed. It was within the power of congress to pass laws reasonably regulated to check avoidance of a tax."

We recognize, of course, that penalties can be imposed for failure to distribute current profits, if the

failure is for the purpose of preventing the imposition of the surtax on the stockholders. As such the acts would be an aid to the enforcement of the collection of income tax and therefore in legal contemplation a tax on "income" within the meaning of the Sixteenth Amendment.

But if there is only "statutory net income" and no profits in fact dividends to stockholders cannot be declared and paid out of current earnings.

Under such circumstances a dividend could only be paid out of capital. Profits earned in prior years are deemed to be capital **(Eisner vs. Macomber, 252 U.S. 189; Willcutts vs. Milfore Dairy Co., 275 U.S. 215).** So that if resort must be had to original capital or added capital or earnings of previous years which were passed to surplus account, the penalty would be on the failure to distribute "capital" or "property" and not on income.

In the case at bar the corporation ended both years' operations with an actual loss. It had no current earnings or profits which could under any proper business practice be distributed as a dividend to stockholders. For the purpose of determining the existence of distributable profit it is immaterial whether the loss arose from sale of securities or sale of merchandise or accident or fire or excessive operating costs. Whatever the reason the fact remains that it had no profits in fact in those two years and hence could make no distribution of dividends unless it resorted to earnings of prior years.

We submit that unless the acts are construed as applying only to cases in which there are actual profits in the current year available for distribution, that the acts are invalid because they would not impose taxes on "income" but would constitute a penalty for failure to distribute "property" or "capital".

The Sixteenth Amendment does not authorize the Congress to impose a tax on "undistributed profits".

In **Linder v. United States, 268 U.S. 5—45 S. Ct. 446,** the Court held:

> "Congress cannot, under the pretext of executing delegated power, pass laws for the accomplishment of objects not instrusted to the federal government. And we accept as established doctrine that **any provision** of an act of Congress ostensibly enacted under power granted by the Constitution, **not** naturally and **reasonably adopted to the effective exercise of such power, but solely to the achievement of something plainly within power reserved to the states, is invalid and cannot be enforced.** (Citing cases.) In the light of these principles, and not forgetting the familiar rule that 'a **statute must be construed,** if fairly possible, so as **to avoid** not only the **conclusion that it is unconstitutional, but also grave doubts upon that score',** the provisions of this statute must be interpreted and applied."

In **Helvering v. City Bank Farmers Trust Co., 296 U.S. 85,** the Supreme Court said:

> "Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The **test** of validity in respect of due process of law is **whether** the **means adopted** is **appropriate to the end.** A legislative declaration that a **status** of the taxpayer's creation shall, in the application of the

> tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, **if reasonably requisite to prevent evasion,** does not take property without due process. But if the means are unnecessary or **inappropriate** to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guarantee of due process is infringed.
>
> . . . .
>
> "There are, however, **limits** to the power of Congress **to** create a **fictitious status** under the guise of supposed necessity. Thus it has been held that an act creating a conclusive presumption that a gift made within two years prior to death was made by the donor in contemplation of death, and requiring the value of the gift to be included in computing the estate of the decedent subject to transfer tax, is so grossly unreasonable as to violate the due process clause of the Fifth Amendment."

In **Hoeper v. Tax Commission of Wisconsin, 284 U. S. 206—52 S. Ct. 120,** the Court had under consideration a Wisconsin statute which required the income of the wife and children to be added to that of the husband and father for the purpose of computing his income tax. The statute was sustained by the State Supreme Court "on the ground that the statute was **necessary to prevent frauds and evasions** of the tax by married persons." The United States Supreme Court held:

> "The claimed necessity cannot justify the otherwise unconstittuional exaction."

The case most often cited in support of the validity of taxes on undistributed profits is the case of **Hel-**

vering v. National Groc. Co., 282 U.S. 932. That case involved the **Section 102 tax,** formerly **Section 104.** The court sustained the Act because,

> "It merely lays the tax upon the corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. **'Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose.'** United Business Corporation v. Commissioner, (2d Cir.) 62 F. (2d) 754, 756."

An act which imposes a penalty "on undistributed profits" when there are no profits in fact cannot be sustained as an act "to prevent imposition upon their stockholedrs of Federal surtaxes" nor as an aid to the collection of income tax, because the stockholders would in no event be subject to additional tax when there were no profits available for distribution.

In **Eisner vs. Macomber, 252 U.S. 189,** the Court had under consideration Section 2 of the Revenue Act of 1916 which provided that "net income" should include "stock dividends" and that stock dividends be "considered dividends". The court in holding the act invalid said that it cannot be construed

> "as inseparable from the interpretation of the Sixteenth Amendment"

and it held:

> "It is manifest that the stock dividend in question cannot be reached by the Income Tax Act and could not, even though Congress expressly declared it to be taxable as income, **unless it is in fact income."**
>
> . . . .
>
> "A proper regard for its genesis, as well as its very clear language, requires also that **this amend-**

> **and startling doctrine, condemned by its mere statement, and distinctly repudiated by this court in the Schelsinger** (270 U.S. 250, 46 S. Ct. 260, 70 L. Ed. 557, 43 A.L.R. 1224), and Hoeper (284 U.S. 217, 52 S. Ct. 120, 76 L. Ed. 248) cases involving similar situatioans. Both emphatically declared that such rights were superior to this supposed necessity.
>
> . . . .
>
> "However, whether the latter presumption be treated as a rule of evidence or of substantive law, it constitutes an attempt, **by legislative fiat, to enact into existence a fact which here does not, and cannot be made to, exist in actuality,** and the result is the same, unless we are ready to overrule the Schlesinger case, as we are not. . . . ."

CASES CITED BY APPELLANT

Appellant cites **Helvering vs. Northwest Steel Mills, 311 U.S. 46, Crane-Johnson Co. v. Helvering, 311 U. S. 54, and Foley Securities Corporation vs. Commissioner, 106 F. (2d) 731,** in support of the validity of the surtaxes in question as applied to the taxpayer in the case at bar.

The cases cited have no application. In all of the three cases the taxpayers **actually earned profits available for distribution** in the current tax year. In the **Foley case** the profits were **actually distributed** as dividends. Those cases merely decided that the acts were valid when applied to actual profits.

Emphasis was placed in those cases on the fact that the tax was imposed on the earnings of the "**current year**". They preclude the idea that penalty can

be imposed for failure to distribute earnings of prior years.

In the case at bar the situation is reversed. Here there was no "statutory income" and no profits available for distribution in the current year. There was a decrease in surplus in each of the tax years in question. There is not the slightest suggestion in those cases that the acts would be held valid if construed to impose the penalty for failure to distribute profits when there were no profits in fact.

The Supreme Court did not in the **Northwest Steel Mills case** "reject" the contention made by appellee in the case at bar. That contention was not made and could not be made in that case because as already pointed out the taxpayer had actually earned profits (not merely statutory income). It was income in the current tax year. The validity of the act as applied to a case in which there are no profits in fact was not raised, discussed or passed upon by the Court.

In the case of **Helvering vs. National Grocery Co.**, cited by the appellant, the taxpayer corporation had actual profits (not statutory income) of approximately $700,000.00 after payment of Federal income tax and the payment of salary of $104,000 to the sole owner of stock of the corporation. It involved Section 102 of the Revenue Act imposing a surtax upon the undistributed profits. It was held to be constitutional as applied to the taxpayer in that case because it was applied to actual profits and as such it was an incident to the collection of the surtax on stockholders.

There is no suggestion in that case that the act would be held constitutional if applied to a case in which there are no undistributed profits in fact in the current year.

The reasoning employed in that case supports our contention that the penalty imposed by these acts would be unconstitutional if construed to permit imposition of the penalty when there are no profits in fact available for distribution to stockholders.

It is argued (p. 28) that "deductions are matters of Congressional grace" and the case of **New Colonial Co. vs. Helvering, 292 U.S. 435**, is cited. The term "deduction" is there used in a limited sense. It has reference to the purely **arbitrary deductions** which do not relate to the factors entering into the actual determination of profits. The deductions referred to are such as exemptions for the head of a family, for dependents, dividend receive credits and other purely arbitrary deductions which do not by proper accounting methods go to determine the profits or losses sustained in a business.

This dictinction was very clearly pointed out in **Davis v. U. S., 87 Fed. (2d) 323 (2d Cir.)**. (See text of decision, p. 86 of Appendix.)

CONCLUSION

The judgment appealed from should be affirmed.

Respectfully submitted,

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APPENDIX

In **Forston vs. Commissioner of Internal Revenue, 47 B.T.A., Case No.** 26, decided June 23, 1942, the taxpayer was in the contracting business. In 1926 and 1927 it received bonds in payment for services rendered under a construction contract. It disposed of the bonds in 1936 at a loss and took a deduction in that year. The Commissioner disallowed the loss except to the extent of $2,000.00. The taxpayer was **not** in the business of buying and selling bonds but had on numerous occasions received bonds in payment for services rendered under construction contracts which the taxpayer later sold. The Board held construing the act as amended:

> "The facts show clearly that it was the custom in the business of doing construction work for levee districts to make payment for the work in its bonds. . . . . The intent always was to sell such bonds . . . . The Company's receipt of the bonds in question in payment for work done, therefore, was not an isolated instance of receiving bonds. . . . . The general depression made it impossible for the company to sell the bonds, but the original intent to sell them remained. The business adversity did not convert the original purpose to sell the bonds into a purpose of investment.
>
> "The facts leave no doubt on the point that the bonds came into the company's possession as a necessary incident to the conduct of its business—to the sale of its services—and they were not received or intended to be held as a capital asset. Disposition of the bonds through sale was likewise essential to the carrying on of its business.
>
> "Under all of the facts it is held that the loss sustained was a loss upon property held primarily for sale to customers in the ordinary course of business. The loss is deductible as an ordinary loss.

> Respondent is reversed on authority of the cases above cited."

In **Hercules Motor Co., 40 B.T.A. 999,** the taxpayer received trade acceptances in payment for merchandise sold. The trade acceptances were sold at a loss. The Commissioner disallowed the loss contending that it arose from the sale of capital assets. The Board held:

> "Here the trade acceptances related directly to the sale of the petitioner's products to Amtorg. They had become a usual and regular factor in the petitioner's transactions with that customer and the sales were accomplished largely through the means of such obligations. The receipt was thus necessary to the normal conduct of the petitioner's business. Their disposition likewise became essential. Petitioner offered them to several potential buyers, finding a customer in J. H. Leander, Inc. Petitioner had sold acceptances to other buyers in other years. Such activities, in our opinion, come within the purview of the statutory phrase 'held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

In **Quaker Investment Co. vs. Commissioner, B.T.A. Memorandum opinion, Docket No. 88723, April 12, 1939,** the Board held:

> "In General Counsel's Memorandum 9958, Cumulative Bulletin X-2, pages 158 and 159, it was held:
>
> ". . . . this office is of the opinion that a person who buys and sells securities for his own account exclusively may be engaged in a trade or business **even though he cannot be treated as a 'merchant' or 'dealer in securities.'** and that in a case where property is held primarily for sale in the course of a trade of business section 101 of the

Revenue Act of 1928, pertaining to capital gains and losses, and the corresponding sections of Revenue Acts of 1926 and 1934 do not apply, regardless of whether the transaction results in a gain or in a loss."

"The facts here plainly show that the petitioner was **organized for the very purpose of purchasing and selling securities** . . . .

. . . . Since the securities in question were held primarily for sale by the petitioner in the course of its regular business, the Board is of the opinion that there is no merit in the respondent's contention that the profit realized from the sale of the securities was from a sale of capital assets."

Income tax ruling 3253—1939—one cumulative bulletin, Part 1, Page 178, is as follows:

"Advice is requested in the case of the M Corporation relative to the dividends paid credit provided in Section 27 of the Revenue Act of 1936 in the computation of surtax on undistributed profits imposed by Section 14 of that Act.

"The M Corporation keepse its books of account on the accrual basis. At the close of business on December 31, 1936, it had no accumulated earnings and for the calendar year 1937 its books showed net earnings or profits of $5,000 after taking into consideration a loss of $5,000, during the year from the sale of securities. As the corporation for Federal income tax purposes, was limited to a capital net loss of $2,000, its net income for such purposes amounted to $8,000. The amount of $8,000 was distributed to stockholders during the year. The question involved is the amount of the dividends paid credit allowable to the corporation.

. . . .

"While the corporation's net income, for Federal income tax purposes, was $8,000, in determining its actual earnings or profits for the year available for distribution as dividends this amount must

be reduced by $3,000, the amount of the loss not allowable for income tax purposes. Furthermore, a proper reserve for the payment of accrued income taxes is deductible in the computation of the earnings or profits, which, in this instance, amounts to $820. **Accordingly, the earnings or profits available for distribution as dividends amounted to $4,180** ($8,000 less $3,000 and $820). (Cf. G.C.M. 2951, C.B. VII-1, 160 (1928). Since a dividend paid credit is not allowable when the distribution is not paid out o fearnings or profits, and since only $4,180 of the $8,000 distribution in 1937 by the M Corporation was so paid, the corporation is entitled to a dividends paid credit of $4,180 under section 27(a) of the Revenue Act of 1936."

In **Weyerhauser vs. Commissioner, 33 B.T.A. 594,** the Board held:

"Inferentially he (Commissioner) argues that the phrase 'earnings or profits' should be construed to be synonymous with 'taxable net income'; that since the company had no taxable net income, the distributions to its stockholders were not distributions of earnings and profits and hence were not taxable. Manifestly, this contention cannot be sustained.

. . . .

"'Net income', in the language of the statute (Sec. 21, Revenue Act of 1928), 'means the gross income computed under section 22 less the deductions allowed by section 23.' Gross income, as defined by section 22, includes gains, profits and income derived from salaries, wages or compensation for personal services, from professions, vocations, trades and businesses, as well as from interests, rent, dividends, securities and 'income derived from any source whatever.' The section, however, specifically provides for the exclusion of life insurance, annuities, gifts, bequests, devises and interest upon the obligations of a state, territory or any political subdivision thereof.

"The deductions allowed include all ordinary and necessary expenses, interest, losses, bad debts, depreciation, depletion, net losses of prior years to the extent provided in section 117, dividends received from domestic corporations, and dividends from a foreign corporation deriving more than 50 per cent of its gross income from sources within the United States.

"In determining the 'taxable net income' of a corporation, in addition to the deductions set forth above, certain credits are allowed by section 26. It is apparent, therefore, that **'taxable net income' is purely a statutory concept.**

"Earnings and profits, on the other hand, are not defined by the act; but they have a settled and well defined meaning in accounting. Generally speaking, they are computed by deducting from gross receipts the expense of producing them. (Citations.) Thus, **under the ordinary method of accounting, in computing earnings and profits there will be deducted, not only the items shown above, but others which are not, under the statute, deductible in computing taxable net income.** In this classification may be listed such items as extraordinary expenses, charitable contributions, taxes paid the Federal Government, and taxes assessed against local benefits tending to increase the value of the property. (Citations.) **Again, many items, such as interest upon the obligations of a state or political subdivision, tax-free Federal securities, and dividends from other corporations, must necessarily be considered in computing earnings and profits, though forming no part of taxable net income.**

. . . .

"But it is argued that the statutory net loss as defined by section 117, 'is a pure business loss', and should be considered in computing earnings and profits for 1928, 'without differentiation from other losses allowed as deductions by section 23'. This argument loses sight of the fact that **Congress, in enacting section 23, was concerned only**

> **with deductions to be allowed in computing net income; it was neither defining earnings anr profits, nor providing a method for computing them."**

In Davis vs. U. S., 87 Fed. (2d) 323 (2d Cir.), the court said:

> "It will be well to note at the start that our scheme of income taxation provides for a method of computation whereby all receipts during the taxable period which are defined as a gross income are gathered together and from the total are taken certain necessary items like cost of property sold; ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion and the like in order to reduce the amount computed as gross income to what is in fact income under the rule of Eisner v. Macomber, 252 U.S. 189, and so lawfully taxable as such. In this way true income is ascertained by taking from gross income as defined that which is necessary as a **matter of actual fact** in order to determine what as a matter of law may be taxed as income. While such subtractions are called deductions, as indeed they are, they are not to be confused with deductions of another sort like personal exemptions; deductions for taxes paid; **losses sustained in unrelated transactions and the other like privileges which Congress** has seen fit to accord to income taxpayers under classifications it has established. While the first kind of deductions are inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress; the only restriction being that it **does not act arbitrarily so as to set up in effect a classification for taxation so unreasonable as to be violation of the fifth amendment.** Such deductions as distinguished from the first kind, are allowed by Congress wholly as a matter of grace.
>
> . . . .
>
> "The loss which the appellant tried to deduct

from his **unrelated** income falls within the second class of deductions of which mention has been made and so its limitation as in Sec 23(r) was one which Congress could control in its sound discretion without apportionment."

In **Corporate Investment Co. v. Commissioner, 40 B.T.A. 1156,** the Board of Tax Appeals held:

"If Congress had intended to penalize the corporation for accumulating a surplus **in prior years** or for failing to distribute such a surplus in the taxable year, it would hardly have measured the penalty by the earnings of the current year or relieved the corporation from the penalty upon the condition that the earnings of the current year were distributed to or reported by the stockholders. . . Thus it appears that Congress was thinking in terms of **current income** and **current gains and profits** when it enacted the provisions of Section 104. The Bureau has always interpreted similar provisions of section 104. The Bureau has always interpreted similar provisions as referring to 'gains and profits' of and 'availed of' **in the current taxable year.** O.D. 188, 1 C.B. 182; I. T. 1572, C.B. II—1, 139. The decisions of the Board are to the same effect. United Business Corporation of America, 33 B.T.A. 83; remanded, C.C.A., 2d Cir., Aug. 31, 1936; Almours Securities, Inc., 35 B.T.A. 61; affd. 91 Fed. (2d) 427, (C.C.A., 5th Cir.); certiorari denied, 302 U.S. 765; Dill Manufacturing Co., 39 B.T.A. 1023."